ИНСТИТУТ ЗА ИКОНОМИЧЕСКИ ИЗСЛЕДВАНИЯ НА БЪЛГАРСКАТА АКАДЕМИЯ НА НАУКИТЕ
ИКОНОМИЧЕСКИ ИЗСЛЕДВАНИЯ
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MODERN FIRM THEORY AND ITS PRINT ON CORPORATE GOVERNANCE

A number of previous projects on corporate governance, accomplished with the participation of the author (Dimitrov et al. 2014; Mintchev et al. 2007; Tchipev, 2009 and others), pointed out the fact that the set of instruments, regulations and good practices of corporate governance are a product of a more or less ***predetermined*** *choice; of the firm specific creation and functioning in a certain economic system. Even more, the very firm, (called in general* ***corporation*** *or, sometimes,* ***company*** *with the same meaning) - being itself a subject of analysis and influence by the corporate governance is also a "datum". There are many hypotheses on the reasons and nature of these specificity, starting from the different legal system applied in the different countries, through the varieties of corporate finances systems, to the nature of the firm in general. The answers are not quite satisfactory. The current paper studies in a broader methodological frame the characteristics of the modern firm, which define the features, interact and determine the choice of a model or system of corporate governance.*

The analysis starts with the relation of the corporate governance to the institutional nature of the firm. The second section outlines the problems of defining the firm (the "paradox of the firm") in the standard neoclassical economics. The third section draws special attention to the criticism of the transaction costs approach *as defining the firm. The fourth section shows its contradiction with the other axioms of the classical and neoclassical economic paradigms and holds the thesis that the firm cannot be understood that way but only through its institutional nature. In the fifth section, with the help of the General Systems Theory, the firm is set in a wider frame of its relations with the market in general and the exchange of value (or utility, depending on the chosen explanatory model). The last section outlines the final conclusion that the firm (corporation) functions (through the value/utility mechanisms) as a* base unit of distribution*, which determines its contribution to the whole set of goods. Thus, the categories* ***firm and corporate governance*** *are in certain mutual order, and it creates the mentioned predetermination. The latter requires and suggests certain solutions for corporate governance adequacy. More concrete answers are also offered, for example to the question why the "stakeholders" cannot (and should not) be an object of the corporate governance.*
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Introduction

The results of many previous projects on corporate governance have shown that there is a need to identify, define and position as clearly as possible the characteristics of the modern firm in a broader methodological frame. These characteristics specify, interact and determine the choice of a model or system of *corporate governance*.[2]

There are many hypotheses on the reasons and the nature of these features, starting from the legal system applied in the different countries, through the corporate finances system, to the nature of the firm in general. The instruments, regulations and good practices of *corporate governance* are a product of a more or less *predetermined* choice, of the specificity of the firm creation and functioning in a *certain* economic system. The most obvious, but not only "datum", which encounter those who study and regulate the corporate governance, is the classical division between the national economic systems of those operating in a *constitutional* legal regime and others - in a *"common law"* regime.

The firm (generally a *corporation*, often called company) is an object of analysis and influence by the corporate governance. This *ex ante* predetermination requires studying of the character and nature of the firm as an economic agent. The problem is a actual and necessary stage of the work on corporate governance, since, on one hand, it forms the trajectories of development of the corporate governance system, and on the other, it predetermines to a great extent its chances for success.

The study of the character and nature of the firm requires a careful view and redefining of the existing approaches and theoretical paradigms explaining the firm. Special attention should be drawn to the critical rationalization of the transaction costs approach, which has a leading role in defining the firm today.

This forms the object of the current analysis – the modern corporation, and predetermines its goal – to try to study the features of its institutional nature, to reveal its role as a system-defining element according to the Systems Theory, and as such - predetermining the corporate governance. Subject of analysis are all those features, which build the corporation as a *specific* firm, as the most "objectified", separated, and independently existing to its "subject" (individual or group), which has structured and placed it in the economic, and more broadly, social space. The main problem of the analysis is how and why the corporate governance set appears predetermined to the company in which it's being applied.

Methodologically, the study is based on the institutional and evolutionary approach, together with the traditional methods of induction and deduction. Results are subject to development and does not claim comprehensiveness.

The analysis includes several sections. The first section studies the relation of the corporate governance to the theory of the firm. The second section outlines the *"paradox of the firm"* and shows how it emerges and which methodological peculiarities of the neoclassical

[2] *Corporate governance* is namely "governance", and not "a management", as the Bulgarian term (korporativno upravlenie) suggests. So, the proper meaning of the term is a rather mix of overseeing and control, and it is interdisciplinary placed in the economics, as in the law and in the managerial sciences as well.

(mainstream) economics are in its base. Special attention is placed on criticism of the transaction costs approach as defining the firm. Shown are its contradictions with the other postulates of the classical and neoclassical model. Reasoned is the thesis that the firm cannot be explained through this model but only through the institutional nature of the firm.

Further on, with the help of the *General System Theory*, the firm is placed in a wider frame of its relations with the market in general and the exchange of value (or utility, depending on the chosen explanatory model). The final conclusion is that both categories – firm and corporate governance are in certain mutual dependency, and that it creates the mentioned *predeterminetion, which on the other hand* requires and offers certain solutions for corporate governance adequacy. During the analysis more concrete answers are shown, like to the question why the "stakeholders" cannot (and should not) be an object of the corporate governance.

1. Corporate Governance and the Institutional Nature of the Firm

Corporate governance, which we chose as a starting point of the analysis for its role in the functioning of the firm, has a very important feature. It determines our objects of study – *the corporation*.

1.1. The Corporation – Object of the Analysis

Generally we talk about firm organization, firm management, etc., but we are indifferent to the vast variety of legal and economic characteristics of the modern firm. To a certain degree it means reducing it to a black box (if we use the systems theory language), since we implicitly assume that all firms have *equal* deepest nature as an economic subject.

It is misleading, the variety misleads. It goes out of the range of the simple variations and, after certain process of complication, changes the nature of the firm. Thus, the real, full, unfolded characteristics of the chosen here object of study are present only in the incorporated structures, which we will determine as *corporation*. They have an economic structure, unlike the sole-proprietor firms, family firms and partnerships[3], where the merger of the object and subject deprives them of development of economic structure.

Economic history is very indicative in this sense – the history of the firm is actually a history of its objectifying, of the separation of its subject – first formally, as a function, and later legally as well. The American institutionalism clearly underlines the genesis of this process, stating that the institutions of the capitalism are result, at least partially, of acquiring a status of "juridical persons" of collective social formations - the modern view on the sovereign *state* as first example (Bazzuli, Dutraive, 2002).

[3] Partnerships have no principle difference with the sole-proprietor firms – just few people gathered to act in cooperation.

The analysis of J. Commons is even clearer. He presents the formation of the firm as a gradual separation of ownership and sovereignty, and following delegating of power from the state to the economic organizations – *corporations are creations of the sovereign power of the state* (Commons, 1950).[4]

Applying the instruments of the evolutionary analysis allows the corporations to be considered as continuing to evolve and develop to new, more complex forms, unlike the historically oldest firms.

The corporate governance and the corporation, as a juridical form, as a specific person, are determined and mutually defined. This statement does not deny the role of other characteristics of the incorporated firm, for example joint ownership. However, the latter also requires and is determined by the *corporate governance*, since it harmonizes the interests of the multitude of owners. Thus, corporate governance becomes a criterion for maturity and development of the firm.

Ownership requires the presence of free people, law-based state, economic freedom, and by defining them it defines itself as a private ownership. In the same way, corporate governance defines and is self-defined through the corporation.

Corporate governance has a very important role for the functioning of the firm, which is the main reason for the choice of it as a starting point of the analysis.

The *corporate governance* approach to the analysis of the firm leads to the conclusion that the corporation has own and complex *actual* nature, i.e. it has structure, development, variety of functions, etc. Its characteristics, features, etc. are outlined as:

- Not reducible to intra-firm analysis, i.e. they are provoked by external, or higher level, systems;
- Accessible for analysis at another level of abstraction.

In other words, these are features that cannot be understood, evaluated, modelled and managed through analysis of the *firm (corporation)* but they need to be approached as a product of the whole system, in which they function.

The issue of the nature of the modern firm is old enough and well patinated in time to be able to hinder the scientific interest. Many acknowledged names of the economic and management science have studied it with different but not decisive success. The reason seems clear – the problem attacks the fundament of the economics, with the extreme inconvenience of making it from outside, from the economic system as a whole, and through the prism of the economic management.[5] Moreover, the firm is not just a problem of the economic management but it *defines* the very economic management as a research area. If the firm does not exist or is not an economic phenomenon, then the economic management equals with (or is part of) the economics.

[4] The goals of the study do not allow us to follow the historical side of the problem in dept.

[5] Management (en.); Betriebskunde (ger.); bedrijfseconomie (ned.); gestion d'entreprises (fr;).

This *ex ante predetermination* raises many questions about the feature of the firm as an economic agent – is this feature of the system nation-defined or not, does it have wider boundaries, does it depend on the principle feature of the firm or not, etc. To a great extent this predetermination defines the application of the corporate governance, and the latter determines also the reform in the real sector.

The attempt to trace the relation of the corporate governance with the modern corporation convincingly shows that it depends on the character and the nature of the firm as an economic agent – what is it, how is it structured (and whether there is at all a structure), by whom (or what), how it changes in time and its interaction with the whole economic "environment", etc.

Our attempt also shows that the firm has a structure, differently specified functional characteristics in economic and not technological or strictly management sense. This constructs it as an ***institution***, as an individual *structural object* of the economic system, which like every institution has certain relations, bears and imposes an impact on the other objects, has certain reasons, and leads to certain consequences. In a nutshell, the firm has *development* (in the widest sense of the term *evolution*), and this development is interesting for the economic theory. The last conclusion contributes to the completeness of the determination of the goal and the object of this study – *to try to study the features of its institutional nature of the modern corporation*.

Thus defined, its characteristics situate the firm outside the main premises of the standard (dominant, mainstream, etc.) economic theory.

2. Problems with Defining the Firm in the Neoclassical Economics

2.1. The Paradox of the Firm

In economics the "paradox of the firm" is well-known – on one hand, the firm practically exists (and some!), on the other – the theory ignores it. The paradox appears from a certain theoretical trap due to the simultaneous action of two assumptions in the neoclassical theory.

1. First is the generalizing assumption that the economy is a process of market optimization, which includes also respective allocation of factors of production. *Ergo*, only the economic agents, which follow this process, i.e. have a rational behaviour, have a reason to exist.

Firms are such economic structures[6] that obviously do not use this mechanism in their *internal* relations, which places them automatically outside the neoclassical theoretical scheme. In best case, as far as the neoclassical economics deals with them, it deprives them of an *internal* structure, which practically ignores them.

[6] As mentioned, they are institutions, but we left the more neutral "structures" since the term is not axiomatically adopted in the standard neoclassical lexis.

2. Second assumption is about the *way* the mentioned concept is applied. The neoclassical economics requires ***alternative*** understanding of the optimizing action of the firm and the market.[7] Ronald Coase interprets them as *"what we find outside the firm is clearly alternative to what is in the firm"* (Coase, 1937, p. 388). There is a choice option of *"either-or"* type. In the conditions of the undoubted supremacy of the market, postulated by the neoclassical economics, its alternative – the firm – cannot substitute it, i.e. it (really) *is not* its alternative! Thus, its analysis already completely remains outside the theoretical field of application of the neoclassical analysis. We will get back in more details to the consequences of the application of these two principles in section 2.2. Here, however, we have to mention that the predeceasing classical political economy offers the opportunity of analysis of the firm.

Smith's concept of manufacture and labour distribution is exactly such case (Smith, 2016). *The manufacture is the first production form*, where the economic agent encompasses many persons, and has no legal regulation. The labour distribution is an ***intra*-structural** process in it, which makes it more competitive than the simple economic agents. This, in essence, is a beginning of a serious firm analysis. However, strangely enough, the neoclassical paradigm ignores it, emphasizing rather controversially on the egoistic nature and greediness of the human (Palmer, 2011). Similar is the fate of the thesis of the "invisible hand", which is separated of and opposed to the whole Smith's moral and economic system, as well as many other categories. Smith is alienated from his categorical system and dogmatized.

Of course, the reason for such "selective" reading of Smith lies in the deep disruption between the classical Smith's analysis and the neoclassical economics. The latter proudly proclaims this disruption with the labour theory of value. The disruption is presented as a revolution, the Marginalist one, which has to break up with the base theory of Smith-Ricardo political economy.

Things, however, are not so simple to the other categories of classical political economy. It turns out that some categories are quite valuable for the "revolutionised" political economy as well and should be kept. Above all is the *liberal credo*, which should be kept at all cost, and probably that is why, the new theory prefers to be called *neo*classical, though much later. During this "deep revolution" other odd things happen as well. Besides undervaluing, missing or preferring to neglect many of the classical threads of the analysis, the new theory encroaches some of its own – let's remember the fate of the *"marginal utility"*, the vanguard Austrian concept of alternative construction of value, which is later neglected by the neoclassical one.

Same happens also with the theory of the firm, which becomes a victim of the disruption between the two paradigms. Exactly this "unseen" disruption with all methodological principles and postulates of the classics is a proof for the inability of the neoclassical economics to consider the firm an ***uncompetitive*** mechanism of the market to solve the problem. This can be done only through the *evolutionary analysis*.

[7] Coase calls the market - *price mechanism,* and Williamson identifies the firm and the market as *hierarchy and market.*

2.2. Standard Theory of the Firm

As mentioned, the firm is not an object of own extended analysis, which by necessity imposes a more detailed analysis here of the dominating theory of the firm. We consider a standard theory the neoclassical paradigm, which dominates the economic theory today, and in all fairness is not particularly generous to the firm. First, we will discuss in more details the two concept assumptions (mentioned in the previous section), which lead the neoclassical economics to "omitting" the firm analysis.

The first assumption – about the necessity of a rational economic behaviour in the sense of the neoclassical economics – leads to ignoring the internal structure of the firm, since within it this principle is apparently not applicable. This means that the firm can only be a function, production function, which produces through *contracting* all activities and factors of production, ensuring their *effective* combination. Actually, it does not exist but only creates solutions for optimums, depending on external factors. This again is purely mathematical treatment of the production, solving one function. Defining the price is also nothing more than the cross point of two functions – that of production and that of demand.

Despite its constant mentioning by the economics, especially in micro analysis, the firm is practically not studied and does not exist as an economic phenomenon. Actually, the object of analysis is the market, a single one, where the firms, like the bodies in the Newton's classical dynamics, keep their status until the other participants derive or stop it. Maybe the only difference is that in the economy there are two sets of rules – one for the small (competitive) firms and another for the large (monopoly or oligopoly) firms.

Thus, the analysis of the costs is a matter of neither production nor technology. The firm simply increases them until MC equals MR, which is purely mathematical solution of function and has no relation to the development of the economy or society, as well as to the satisfaction of the consumers. For example, if the neo-natal intensive care units or the replacement of locomotives are too expensive due to price levels, they are simply eliminated, no matter of the consequences. Analogous is the logics of the size of the firm, the volume of production, which often leads to the opposite – increase of production (for example over-construction till the city practically suffocates) as long as it is in the range of the possible and allowed solutions of the production function.

Practically, in the original version the firm is reduced to production function optimizing the different factors by their marginal productivity. The optimization is done by the market, which in the postulate ideal case guarantees best ratio between costs and benefits.

This, by the way, is another point that the neoclassics has "borrowed" from Ricardo's classical theory. David Levine considers that the concept of the firm as a "technical production unit" corresponds to Ricardo's postulate, where the firm is "only an immediate production process and is not a unit of production and realization in the world of capitals" (Levine, 1977, p. 131).

Ironically, when the critical view to the standard, or more precisely - rather early neoclassical theory notices the lack of satisfactory theoretical reasoning of the firm, it finds out an insurmountable contradiction as well. If the market completely solves the questions of the optimization, then what is the reason for the creation of hierarchies (firms)? Is it not a paradox that there are firms at all that should not offer a better solution to the optimization task than the market? Practically, the market is (should be) able to organize every production process as a series (total) of contracts.[8]

3. The Firm in the Transaction Costs Theory – Contributions and Weaknesses

3.1. Coase and the "Nature of the Firm" (1937)

The critical view, which opens one of the heaviest questions in the micro analysis, is the one of *Ronald Coase*. He easily "sees" that the firm is not only left without attention but also without a reason. Coase postulates his ideas in the frames of the neoclassical paradigm and that is why he declares that he tries to "clarify assumptions on which a theory is based" (Coase, 1937, p. 386). Moreover, Coase insists that they should be both "manageable" and "realistic", since the micro analysis uses either "manageable" or "realistic" assumptions, which make its criticism and respectively its task much deeper, more essential than usually perceived!

Thus, to him the firm is omitted in the "manageable" assumptions, i.e. those included in the model of distribution of the factors of production according to the price market mechanism. The few attempts to define are based on such set of assumptions, which aim to reflect more realistically the picture of the live economy, but are not bound to the "manageable" axioms.

The solution, proposed by Coase, is based on the assumption that the market causes *transaction costs (TC)*[9], which, roughly said, make the deals more expensive. That is why he defines the firm through the *necessity to minimize the transaction costs*. Since this assumption would lead to the presumption of the unlimited scale of the firms, transaction costs are subordinate also to the requirement to grow in parallel with the growth of the firm. Thus, the latter end the process by forming an optimal size of the firm. This is not a problem assumption, since it corresponds to the general idea of the behaviour of the costs in the neoclassical analysis.

According to Coase, his solution should necessarily use both basic "Marshall" marginal analysis concepts – marginal analysis and substitution.[10] It situates it inside the neoclassical paradigm. Coase wants *to add* missing link in these assumptions, in order to make the existence of the firm *possible*, and not to destroy the neoclassical paradigm! To some extent this explains why O. Williamson, though considered a neo-institutionalist, actually applies neoclassical approaches.

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[8] Thus, the missing firm theory in the standard approach is not an omission but a logical assumption.
[9] Coase calls them costs for "organization" or use of the price mechanism. Williamson is the one who codes the transaction costs as a term.
[10] The margin and the substitution – "the substitution at the margin" (Coase, 1937, p. 386).

3.2. Oliver Williamson and Transaction Cost Economics

O. Williamson builds an entire theory from the assumptions of Coase. With the *Transaction Costs Economics (TCE)* Williamson reconfirms the theoretical existence of the firm, making contributions, with which actually he just further enriches the nomenclature of these costs and formalizes their analysis. He assumes that:

- Many people have opportunistic behaviour, which, together with the transaction-specific investments in human and physical capital, makes a vertical integration (i.e. growth of the firm).
- Though it is necessary, information is rarely effectively processed.
- Evaluation of *Transaction Costs Economics* is a problem of a comparative institutional analysis.

Moreover, Williamson introduces also new reasons – if the transactions are non-specific, then the market can minimize the transaction costs directly, without a firm. Random and non-standard transactions would profit from some integration between the agents (Williamson, 1973).

Concerning the firm[11], it becomes completely economically justified, with repeating transactions, which include specific investment at high uncertainty. Thus, a situation arises, when the firm is not indifferent to the transactions it makes! The firm can have justified existence with one type of transactions and unjustified – with another activity. It means that *it can emerge independently from the requirement of effectiveness*. It just turns on and off certain transactions from its activity, unrelated to the optimization mechanism.

Williamson interprets this as an addition to the effective functioning of the market, but actually this denies the very idea of market optimization, since if we have many efficiencies (and corresponding structures in the economic space) in reality we deny the neoclassical paradigm about the market as an *ultimate* optimizing procedure. This means that the optimization (if one continues at all to observe such economic behaviour) will happen between better and more effectively organized hierarchies. This replaces the very nature of the market economies.

The opposite assumption – that optimization of economic agents of both market *and* hierarchy type is possible – would mean creation of a *principle* advantage for one side in the optimization process, where all resources will be collected in one agent and the system would block (Jensen, and Meckling, 1976).

Though with different logics, the criticism of Stanley Fischer is very close exactly on this point: "most of all it could be rationalized through adopting suitably specified transaction costs" (Fischer, 1977).

[11] Determined by him as transaction-specific governance structure (Williamson, (1979).

3.3. Institutional Criticism

Besides the main weakness, which we mentioned as "paradox of the firm" regarding the two assumptions in the neoclassical theory – market optimization and ***alternative*** treatment of the firm to the market, there is also a neglecting of the intra-structural analysis of the firm. It is not possible for the economic agent to have structure, internal organization, respective separation of the functions, of ownership from control, and eventually to be an object of *corporate governance*.

Evolutionary political economy would assume (if optimization really acts in the way predicted by the mainstream theory) that exactly the market could generate the firms. That they are just a juridical form (continuation) of the economic agent, represented by the physical person! Why at all the hierarchies (firms) are considered antipodes of the markets? The answer to these questions is a subject of another discussion, but the breaking up with the classics creates the principle inability for neoclassical economists to consider the firm a non-competitive mechanism of the market, which would solve the problem.

Another reason is that the ***internal structure cannot be modelled as a result of the market mechanism***. We have to note that the micro analysis postulates a competitive, oligopoly or monopoly structure, and then models different market answers, but does not produce *different* structures from the functioning of the price mechanism. This is impossible and that is why the used methodology is the second serious obstacle to the real analysis of the firm.

Formalizing some more or less reliable structures, Williamson, and later the whole school of his followers, opens an endless field for speculative analysis on which structure is "more effective" or not, what will happen if we change a small premise, etc. In reality the dynamics of the structures is as big as the dynamics of the price mechanism, and respectively the attempts to "reduce" it are also pointless. Thus, the method opposes the postulates that created it.

There is one more very serious contradiction to the transaction costs concept concerning the functioning of the market mechanism. Adopting these costs, as the work of the neo-institutional school shows, is an endless process of finding newer and newer ones. This means that there can always be a more specific one, and its introduction to a concrete market model could rearrange the whole model. This methodological loop clearly shows the presence of a contradictory assumption somewhere in the very subject. In our opinion, this contradiction is in the very nature of the transaction costs.

4. Contradictions of the Transaction Costs Concept

The assumption of the transaction costs is based on an internal contradiction with another founding principle of the economic system, which is an object of analysis here. First, let's look in detail at the nature of the concept.

4.1. The Nature of the Transaction Costs

Coase bases his concept on quite clear logics, unfortunately, however, too simplified. There are costs due to the necessity to find the "relevant prices". There are also costs for the very "contract". This means that he assumes an additional element to the normal production costs (the latter include also a component for marketing, image presentation, etc.). This component emerges from the very action of the market, the "exchange mechanism", as Coase calls it. This suggests that these are over-costs, imposed and adopted only because of the exchange process. Coase even analyzes this case in a footnote (Coase, 1937, p. 394), where he mentions that turning the economy into one big firm is conceivable. If we give up on the "consumer choice", we can completely eliminate the market costs.

We put aside that it is a direct opening of the door to arguments on the nature of the central planning, which even then is object of heavy debate. More importantly, Coase himself has no doubts that the transaction costs *are not production costs* but costs caused in the exchange phase, and that they can be *optimized* and realized in a normal (or if you prefer capitalist) economy.

We will leave for a moment this debate and will remind one of the biggest merits of the classical economics.

4.2. The Exchange in the Classical Economics

There are some important lines, where the classical economics breaks up with mercantilism. One of them is the relation between the creation of value and the exchange. According to this assumption, the exchange cannot create value. There are many producers; respectively they create goods with certain level of value according to some socially permissible logics in one way or another (the opportunities for Smith are several!). This logics excludes the possibility for creation of even a minimum value in the exchange process, since it would make the closing of the processes and their distinguishing from one another impossible.

If, despite all, the theoretical model allows creation of value *in* the exchange act, i.e. *non-equivalent exchange*, then some very heavy problems of backward loop appear.

On one hand, there is no reason for the exchange acts to stop because of the possibility of making the goods more expensive due to their continuous circulation. This would lead to liquidation of the consumption, i.e. the product will not be consumed. We are not far from the monetary fetishism – the treasure in the hands of the Moliere's miser Harpagon who only counts his coins without using them.

On the other hand, soon the production costs share will become too small in the total volume of trade costs and the production phase of the economic process will *also* become pointless.

Such assumption is not just an abstract construction but suggests two quite specific cases of real economies for its realization.

The first real possibility for it to work is in a very early and primitive phase of market (capitalistic) economy, where the market sector is literary “sunk” in *non-market* ways of production (feudal or family-common) and whose agents function as ***net donors*** for the market system. Roughly, this is the whole period of the *pre-manufacture* economy, when traders, actively functioning on market principle, buy goods from different “suppliers”, who for many reasons cannot reach the market and get their evaluation. The whole British economy in the colonies has functioned on this principle, selling to the villagers via market the cheap textile produced from the cotton bought from the same villagers. This is the infinite power of such model, drawing from the uneven position of the participating agents. It is also its absolute weakness – the moment the genius of Mahatma Gandhi finds a simple way of counteraction by encouraging non-cooperation of his fellow-citizens to not buy British goods but to manufacture them themselves, the model stops functioning, and this eventually leads to independence of India.[12]

Second possibility for existence of economy, which derives (or adds, as is the modern term) value in the exchange process, is if it is realized in *non-equivalent foreign trade*. Actually, it is the base of the economic model of ***mercantilism***. It can and really has certain explanatory function, but only as far as it includes economic agents external to the system. This model, however, is also practically dying out, since the globalization of the world economy makes the non-equivalent trade, in the traditional sense of the term, harder. And yes, of course, at the end the second case of non-equivalent exchange is also reduced to the previous one, because it suggests that one agent in the exchange relation is traditional, or *non-capital* oriented in the mentioned sense.

As a whole, the *classical economic paradigm* solves the mentioned problem by postulating that the economic activity is derived into phases – production, exchange and consumption.[13] In the first phase goods are created (and value, since the classical model is based on the labour theory of the value). In the second phase the goods are exchanged, and in the third phase they are destroyed (consumed). A circle, circular model of the economy is formed. And with two sectors and a market, which binds them. It is the famous two-sector[14] economy model, conveniently placed in every textbook on microeconomics, suggesting that it is an achievement of the neoclassics. Actually, it is defined by the postulates formulated by the *classical political economy*.

If we go back to the opposite assumption that value is created also in the second phase, we see that it turns the model into a non-structured mass of economic acts, deprives it of cyclic recurrence and gives it a random and chaotic character.

[12] The space here does not allow us to go into details, but the non-market “sunkness” suggests promising directions for analysis, raising interesting questions like is market economy functioning in pure form possible without the simultaneous presence of pre-market (non-market) forms such as the different feudal, traditional and other productions, which are more or less non-capital oriented, i.e. they are *more “oeconomicus” than “chrematistics”*, if we use Aristotle’s distinction.

[13] The radical political economy adds the distribution as well, but in the liberal economy it is given in the logics of the first two stages, and in my opinion its differentiation is not necessary.

[14] The third sector – the state – comes much later, and not always.

4.3. Neoclassical Model and the Equivalent Exchange

The fact that the new (marginal) doctrine keeps this point, though it broke most of the elements of the replaced classical paradigm, shows the strength and significance of the postulate of the *equivalence* and *neutrality* of the exchange. However, in the neoclassic theory, this assumption is difficult to be found out because of the *implicit* way of defining the fundaments of this theory. That is why Weintraub determines it as "meta-theory". "The neoclassical economy is meta-theory. I.e. a bouquet of unclear rules or assumptions for creating satisfactory economic theories. It is a research program, which generates economic theories. Its fundamental axioms are not open for discussion and thus they determine the shared views of those who call themselves neoclassical or just economists without any adjectives" (Weintraub, 1993).

Still, the careful consideration of the nature of the neoclassical model gives enough reasons to state that it also keeps the requirement for the exchange acts (mostly barter) to not increase the value or utility of the exchanged goods.

Most of all, the mentioned circular model, on which this economics builds its logics, reveals this principle.

To the same conclusion leads the (barter) defining of the exchange in the neoclassical economics – equivalent process, which really starts with different evaluations of the two involved agents for the utility of "own" respectively "others'" exchanged good. The process continues till the two contractors equalize the marginal utility they derive from the exchange act. Then, the exchange is complete, the exchanged relation is objectified in a price, and the two agents are in their optimal state of maximum satisfaction. The neoclassical economics not only requires this but also proclaims it as a sublime goal and most significant achievement of the economy, namely the *optimal (optimised)* satisfaction of the needs of maximum economic agents.

In the exchange of *goods for money* the logical chain is complicated from the assumption that the money has no decreasing marginal utility (Austrian school). Generally, however, the process has no difference, since the Austrians simultaneously assume that the money reflects the marginal utility of previous (other) transactions.

The other big debate concerning the application of money (whether it is neutral or not to the market) also deserves attention. In our opinion, it has no relation to the discussed problem, since it concerns the question whether the relative prices of goods change or not with a change in the money supply, but it does not doubt the logics of each exchange act.

The additional argument, that the neoclassical model in its principles also includes the neutrality of the exchange, is in the analysis of the situation – exchange of labour for utility of goods or money. In this case, the pure microeconomic tracing of the process shows that the marginal utility of the refusal of freedom and control over time, which the workers do, equalize to the marginal utility of the goods received in the exchange (or purchasing power).

Moreover, it is added with the macroeconomic requirement of inviolability of the general contribution of each factor of production to the social product. The neoclassical economics breaks up with the logics of Ricardo and Marx that in the production process there is a redistribution of income and product between the owners of the different factors (from the labour to the capital) and insists that each factor receives exactly as much as its contributes to the manufactured product, which on the other hand is determined by its marginal productivity.

Thus, the assumption that in the exchange of labour for money the principle of equivalent is violated would renew in another form the problem, of which the neoclassical economics tries to set free. This argument has rather auxiliary significance, but also underlines the neutral character of the exchange, which in fact is the goal of this diversion in the history of the economic theories.

4.4. Transaction Costs and the Principle of Neutrality of the Exchange

If we return to the problem of the transaction costs, we will see some interesting facts. Most of all, there is no doubt that their adoption violates the principle of neutrality of the exchange phase concerning the total product. Roughly, adding the *market-derived costs*, the logics of Coase, Williamson and others actually ***adds value***, or if we keep to the subjective terms – utility to the created product. And on a completely standard principle, like any other cost. Hence, the agent (in this case the firm since it is the target of Coase) can form also profit, etc.

Now, having in mind that (1) the neo-institutional analysis literary swarms with different types of such costs, and (2) they have claims to approximate the model to the reality, and (3) these costs are made to reveal the whole information necessary for the deal, including all possible consequences from one or other outcome on the contract, with the uncertainty, etc., it becomes clear that this assumption is not just contradictory. It undermines the very logics of the market mechanism. The market starts to function as ***one of the sides in the deal***, it becomes an *economic agent*! And:

- It is clear in advance which side;
- Can change the side during the deal;
- Can even influence both sides simultaneously.

No wonder that the "features" of the concept have deserved the opinion that "(t)ransaction costs have well-deserved bad reputation as a theoretical instrument…" (Fischer, 1977).

This concept contradicts also to other initial premises for the market, like immediate action, free and equal access of all agents to information, etc. Each of them deserves own attention and interest. Unfortunately, the space in the current paper does not allow us to go into details.

As mentioned, it has the characteristics to be true only in the case of merger of the whole economy into one firm. It has extremely unsuitable side, besides the ideological implications, to lead to denial of the market in general, like mechanism for organizing the economy, which is the least contradiction to the practice.

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The analysis here aims to examine whether the assumption of presence of transaction costs can solve the problem of the lack of logical determination for existence of the firm in the frames of the neoclassical paradigm.

Constructed as an optimization game between manufactures and consumers, the neoclassical mechanism practically expands its activity only between the different firms, implicitly reducing them to points, to simple variables in mathematical sense, or to black boxes in the systems theory.

The base of this paradigm error is, of course, the mechanical approach, which is dominant in the marginal revolution (and unfortunately till now!). It "atomizes" the economic subjects, on the example of the Newton physics, for which the objects are just "bodies", which move evenly, rectilinear and infinite (if some other power does not influence them), but for which we do not know (and do not care of) nothing more. Thus, the possibility for analysis of their internal structures not only disappears but there is also contradiction between firms and markets, which drags the necessity of *Transaction Costs Economics*.

The most interesting is that the criticism against the *"atomization"* is not at all new for the neoclassical economics. It practically accompanies its whole history – the problems with the firm are only another consequence of this methodological defect.

When the question of the nature, structure and functioning of the economic agent, its development, etc., arises, it becomes clear that they cannot be considered outside the principles, on which certain scientific paradigm is created. And that these concrete principles do not allow denial of the application of the transaction costs concept.

For our task it means that transaction costs theory cannot explain the question of the existence of the firm. The problem of whether and why the firm is more effective on the market is the next misinterpretation in the neoclassical economic theory.

As mentioned, the answer is somewhere else – in the institutional nature of the firm. When it is not just "addressed" but really studied, it will become clear that it is not alternatively opposed to the market but its product and continuation. This will open the way for searching for the answer to the question why it exists. This gives opportunity for further analysis of the firm.

4.5. The Paradox of the Firm – Second View

If we go back to the problem we started with, we can generalize the following:

1. On one hand, there is a paradox of the existence of the firm, which is insoluble without a change of the frames of the *assumptions of the standard theory*.
2. On the other hand, such change would hardly be possible in the frames of the neoclassical theory. The assumption, which is actually an explicit requirement, of a general optimization of every real economic situation, is sacralised, as mentioned in

section 2.2., and its revision is impossible without threatening the very fundament of the model.

3. The attempt of Coase and the neo-institutionalists contains, to say the least, assumptions, which contradict to the entire logics of the model and really lead to other insoluble situations.
4. In the frames of this paradox, the firm remains somewhat undetermined, with unclear and blurred boundaries – its existence does not match in any way, including as optimizing mechanism, since it cannot be such in the presence of a functioning market, nor can it be ignored.
5. The wide application of the term in microeconomics actually envisions the individual firm, as strange as it may seem, since only this way the problem of the "non-optimal internal structure" can be ignored.
6. Thus, besides the original theoretical problems, the researcher faces some purely practical ones as well. Such are the *corporate governance* problems:
   - How is the *corporate governance* situated concerning the firm?
   - Which its features come from and depend on the nature and type of the firm?
   - How can we improve them, so we can reach the best standards of *corporate governance*?

5. An Attempt for a More Systematic Approach to the Firm

The sharpness and depth of the mentioned questions, problems and contradictions require directly asking the question what are the reasons for existence of the firm. The answer to this question imposes the search for a different approach, more complex, based on the system theory.

As a first step of such approach, it is mandatory to make an attempt to see whether the firm and the market are really antipodes (the second assumption discussed in section 2.1.).

5.1. The Firm as an Antipode to the Market?

The counter-position firm-market is the main deviation, which leads us to paradoxes and traps in the analysis of the economic system. If in the marginal period it remains non-focused so the actual object of analysis is a firm reduced only to the activity of its owners, a subject (according to the result in the previous section), Coase and Williamson overcome this. The analysis is generalized for the firm in general, but it is thrown in another direction – the firm is placed in a counter-position to the market.

Moreover, the internally contradictory question what is more effective, better optimized – the market or the firm – raises. Thus, first the nature of the firm is replaced and respectively the way to its analysis is closed.

Even more paradoxically, the market is also given a meaning and significance, which contradicts to its actual function. What is it about?

The next sections discuss somewhat forgotten but proven universal methodological approach to analysis.

5.2. The Market as a Connection, Relation between the Firms

The firm is neither less effective nor more effective than the market. They are incomparable in this way. It is obvious and even axiomatic – let us just remember some key moments of the *General Systems Theory (GST)*.

Ludwig von Bertalanffy defines the system as “elements in standing relationship” (Banathy, 1997). This means, in short, that every system has at least two groups of functioning components – elements and connections between them.

There are also multitude characteristics of each element, among which one stands out and is called systematic. It makes the element belonging exactly to a *certain* system and not to *any* other system, and respectively the system is exactly defined. The qualities processed by a certain elements can be infinite in number, respectively one element can participate in infinite number of systems, which can be arranged and interacting, forming sub-systems, etc.

GST has many applications in the form of dozens of different areas of systematic analysis (some of which with a dozen of sub-areas), starting from archaeology, biology, etc. and reaching the system theory in management, etc. Unfortunately, however, especially in the area of the economic theory, it is completely missing.

That is why it is not strange that the simple question – which are the elements and connections between them, making them participants in the *economic* (exactly economic and only economic) system, is also missing. Respectively, for an answer is used implicit, axiomatic and non-differentiated knowledge, which places the *individual firm* instead of the element (the economic atom), as mentioned. The relations (connections) between them are not discussed at all, or only the most general are mentioned – competition, cooperation, etc. Actually, the real relation between all elements of the economic system is the **market**.[15]

The market is not a *mechanism for efficiency*. It does not make the firms more efficient. They participate with the efficiency they have ensured through innovations (Schumpeter), corporate governance (Coase), etc. Really, some of them drop off the market but others remain, even if they are not among the most effective ones. Moreover, the whole neoclassical (and classical) analysis supposes many firms with different efficiency, in any given moment. If by some reason this number decreases to a certain level (oligopoly) or is concentrated in only one form (monopoly), this is stigmatized (and completely justifiably) as destroying the market.

[15] Here immediately rises the question what happens in those economic systems, which are not based on the market. The short answer is that they are not economic, but distribution systems. The socialism is the perfect example of this – with both its successes and failures (see more in Tchipev, 2000).

The market is ***exchange of values***. It does not generate value, and does not determine it, as the perception for the mechanics of interaction of demand and supply suggests. And it is intelligible. If it was not the case, through a not very sophisticated manipulation of the demand we would reach an incredible concentration of value in very few hands.[16] As mentioned in details in section 3.4.3, in both classical and neoclassical model the main quality of the market is to exchange equivalent values.

The modern analysis of the exchange often leads the neoclassical economics also to another "omission", namely that the exchange is barter in the original marginal model. Exactly in this form the action of the market, described by Menger, is most eloquent – the two contractors increase or decrease the supplied by them quantity of goods until they reach the feeling that they have acquired maximum utility from the deal for themselves, i.e. until they have evened the marginal utility of both goods, as the early fathers of the subjective political economy would put it (Menger, 1950).

Of course, in the extended form of exchange – *goods for money*, the mechanism is principally identical, but then the active process of comparison is more simplified, since the evaluation is made directly in money, which marginal utility is considered unchanged concerning the consumption.

The result of this analysis of the market action is negative for the Austrian subjectivists, who do not manage to achieve the initial goal – to create alternative theory of the value. Very soon it is understood by the Lausanne school, and the marginal utility is replaced with the indifference curves. They seem quite more distant from the final subjective evaluations of the Austrians.[17] The marginal utility is pushed to the corner of the contemporary theory, and the question of the value is practically reduced to a scientific problem – there is a point of intersection between two independent functions, which presents a price, and by default it is always fair, as long as there is no external interference. We will leave this thread of analysis for now and will return again to GST so we can see what the role of the second component of GST is.

5.3. The Firm as an Element of the Economics System

The second side of the system approach of Bertalanffy is the element. The initial notion here is also implicit and to some extent misleading. On one side (the demand) is the individual[18] as an economic agent, and on the other side it is logical to have the same type of contractor. The analysis in both places uses the concept of costs, and compares one production volume with another, more optimal one, and even extremely slowly replaces labour with capital. Still, there are no different real combinations, different sets or

[16] This of course is the tendency today, but there are many infringing mechanisms outside our interest here.

[17] In reality, they are also based on the evaluation of utility, but indirectly.

[18] In reality, often there are talks about "households" but nowhere microeconomics analyzes the collective, whether family or other, consumption. The idea that exactly the individual preferences of one consumer to books and of another to beer are "equalized" is missing. This is what makes the use of the indifference curves, which compare whole ready "sets" with equal utility, so attractive.

structures, which would play the role of economic agent. Thus, in reality this agent is reduced to optimizing individual or hardly to some "household", which members are merged into one producing entity.

In reality, the whole economic activity of the "modern" society is realized in and through more or less complex firms. So, there is no doubt that the firm plays the role of the element of the economic system (in other words the economic agent). Assuming this we reach the main question – how does the firm function in this quality?

5.4. The Firm and the Problem of the Value

Now we have to continue the interrupted analysis of the value. There are some problems, which always concern this concept. Since the market is a mechanism for exchange of "values", "utilities" or whatever we call it, the issue of their formation needs to be addressed.

Historically there are many explanations of how the basic ratios between the exchange relations are determined for the different goods. A short view on the concepts of theories[19], which are not just or only "market", like labour and work time in Marxism or even purely consumption value (without the interference of demand and supply), is found in Tchipev (2007).

More detailed view would reveal interesting things, but this problem also remains outside the direct goal of the current study. However, we have to say that at the end in the neoclassic, as well, the question of the business structure of the prices is placed outside the issue of the utilities, outside the economic problems. In the early Austrian stage of the subjective theory, the evaluation of the marginal utility is openly "non-market", since it is generated *from outside* – from the "preferences" of the consumers, which are psychological quantities! Only after the actual "marginalization" of the marginal utility, this tautological functionality, greatly conveyed by Marshall, is reached – that it is unclear which blade of the pair of scissors makes the price, the upper or the under!

Whether we will use the category of the classicists – *value*, or from the neoclassical language – *utility*, the question of what determines the differences (exchange relations) for the different goods remains. Still, what defines this (sometimes unimaginable!) difference in the utility? How is the latter determined for new goods? Why are we not allowed to

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[19] Starting with Aristotle, the search for the "Holy Grail" of the economic theory continues already for 2500 years. The Middle Ages and the early years of the mercantilism determine the value by the consumption qualities and even the "utility" of the goods (like Davanzati and his Lecture on Money, 1588). Nicholas Barbon writes that "the value of all wares arises from their use". In 18th century Ferdinando Galiani not only studies the utility, but implicitly describes even the term of the diminishing marginal utility, without formulating it. The classicists (from Petty to Marx) defend the thesis that all exchange relations of goods can be explained with the "natural" price, dominated by labour. In parallel, the "utilitarian" scientific logics continues its existence already till the famous John Law (who bankrupted France in 1720). He interweaves the two explanations of the value – the one of the utility and the one of the demand, but the real revolution is the work of Menger and Jevons, of course (see more in Tchipev, 2000).

evaluate (and consume) the goods produced at price lower than the level of their *average variable costs*?

Obviously, since the market exchanges equivalent values between the firms, the latter have significance for the "construction"[20] of the values. What is that significance?

The firm creates *delimitation* of the process, sets limits.[21] It cuts the value/utility, which is formed in the scale of the whole economy, regionally, nationally and (nowadays) even globally. It determines the limits of optimization, the profit centre, the object of cost-benefit comparisons, etc. It is also determining the sizes of the firm. It grows until it is optimal. Moreover, with its actions and increase or decrease, it determines also the structures of the market – how from competitive it becomes oligopoly and vice versa; with applying anti-trust measures it returns to competitive status.

Of course, this interpretation changes our perception of the value as well. Like the one on the market, it is also implicit, intuitive as for something "solid", essential, which "is being created" and might be poured, accumulated, etc. somewhere "inside" the product. The Marxism even defines a separate term for labour – *abstract* one – which creates value invariantly, independently from its specific good-bearer, as an *abstract embodiment* of the worker's effort, creating only the conditions of own exploitation.

In reality, the value or utility is a *principle/mechanism* of distribution, ***and not a substance, which is in the goods***. And of course, it is ***distribution*** of goods, prosperity (wealth), economic status in the broader sense of the term.

If in the basis of this distribution are the costs, (and they are always present[22]), this sets the basic structure of the exchange relations. From that moment on, the mechanisms are different in the different epochs. Aristotle suggests only production time. Smith suggests labour, as well as costs, as well as demand, etc. All deviating upward or downward factors can participate (and actually ***do*** participate) – from the differential fertility or location (Ricardo) through the "spphisticated" labour (Marx) to the subjective "satisfaction" (Menger) or the entrepreneur's contribution (Schumpeter). They change more or less this structure (somewhere even unrecognizably). Basically, it appears to me that everything about the value is debated in debt.

The new approach here is perception of the firm as a generator of value in (certain?) limits, creating a grid of "values" that pulse, increase, shrink and exchange equivalents in accordance with the market principles. This idea, in another context and not so explicitly, has been presented in Tchipev (2007). It represents an evolutionary economic logics. It does not assume necessarily a balanced, optimal, etc. state – the different firms can progress

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[20] "Construction" is free enough term, unlike "creation" for example, which immediately imposes the idea of "production" of the value.

[21] Evolutionary, as the cell sets the beginning of the living organism by delimitating itself from the environment forming a cell wall, the firm also delimitates itself from the environment and the other firms through its limits of optimization, creating the structure of the economy.

[22] Even in the neoclassical model, where the supply curve cuts the production volumes under the levels of the average variable costs, thus excluding those supply volumes that do not cover the variable costs (labour, resources, materials, etc.).

or regress, without any relation to the economy as a whole (as it is in reality). Of course, when the status is strongly monopolized the firms can (and actually begin to) compete franticly, which can threaten nature, resources or climate, not counting the dehumanization.

Each of these and many other threads of the analysis can be studied separately, but our focus is on the corporate governance. That is why the last section will focus on that.

Conclusions

Applying the systematic approach to the firm, we can draw some conclusions on *corporate governance*. The first conclusions come from and require the application of the frames of the institutional, particularly evolutionary, paradigm. According to the conducted analysis, the firm is a complex developing institution, which takes different forms in time, acquires and complicates certain structure of supervisory and control governance and since the developing of the modern economy of market relations, confirms as its most mature form - *the corporation*. In the concrete case, functioning of the corporate governance of the latter complies with the specifics and essential characteristics of the firm within the economic system, taken in its highest degree of generalization.

These characteristics construct the firm (corporation) as a basic unit of distribution of determine its contribution (and that means of its *share*) in the whole multitude of goods, through the *mechanisms of value/utility*. The same can be interpreted also as "creation" of the latter.

And here, we reach a key moment, quite controversial perhaps. If the corporation is "the cell" of value/utility, that is logical to set also its main goal – maximization or optimization of this value. This means keeping the "the right" for claiming the "residual value" (Fama and Jensen, 1983) for itself – the corporation, which personalization is only and exclusively within the circle of its shareholders. This excludes the possibility of any other "stakeholders" to be subjects of profit, and respectively of *corporate governance*. This resolution of the problem with the scope and structure of *corporate governance* is entirely objective, since it refers to the characteristics of the very corporation as an economic agent.

Finally, the existence of the corporation is completely possible not just with the market, but within the framework of the market, under certain conditions. These conditions include acknowledgment of the institutional nature and characteristics of the firm, i.e. refusal to reduce it only to production function. Thus, a way for the real analysis of its nature, characteristics, development etc. is open. Further, many more consequences and serious changes in the assumptions of the theory can be outlined which are not a subject of analysis here and which integration in the frames of the dominant neoclassical economic theory seems impossible.

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